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MIAMI BEACH, FLORIDA 9-11 DECEMBER 2008
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The Perfect Economic Storm: A Global Energy, Financial and Air Transportation Crisis

12/11/2008
9:00 AM - 10:15 AM (0900-1015)

Presented by: Doug Ducate, CEM, CMP, Roger
Martin-Fagg and William Swelbar

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The Perfect Storm – the economic outlook

A perfect storm occurs infrequently, when two or more weather systems collide and create a single storm with energy which is a multiple of its components. Almost impossible to predict, the storm unleashes a pattern of weather which forecasters have no previous experience of, and which has unpredictable consequences.

We are in a perfect economic storm caused by three separate crises which alone would be manageable, but when combined render Central Banks and Governments almost powerless. These are a Financial Crisis, a Food Crisis and an Energy Crisis. Their combined effect will put the world economy close to recession and the Western world in recession. But we must consider the possibility of a Global recession and even a depression if the Banking system following partial nationalisation, still remains undercapitalised.

Over the next three years we will see rising inflation, falling growth, rising unemployment, falling house prices, rising bankruptcies, falling new business start-ups, rising share issues, falling share prices, rising budget deficits, rising government spending, falling interest rates, falling credit supply. And some things that we at present cannot predict, remember this is a perfect storm.

Some facts

US house prices have fallen the fastest since records began. The US money supply in the three months to June has fallen at an annualised 9% (this is an absolute fall, not a reduction in the rate of growth). In the UK house prices are down 14% since last July, and in Sept, mortgage lending was two-thirds the level of a year earlier. A rise in just 50 basis points in defaults on the UK mortgage book will wipe out most of the profits for UK banks on this business(which is 50% of their sales) This is happening as I write.

In the USA Fannie Mae and Freddie Mac support £2.65 trillion of mortgages with £41 billion of capital. They only would accept 80% of valuation loans from the issuing banks, but over half their book consists of loans made between 2005 and 2007, and many prices

are now below 80% of the 2007 value. They needed another £50 billion of capital injection which came from the public sector. So Fannie May has come full circle, from state owned development bank set up in 1938, via privatisation in 1968, to renationalisation in 2009. Freddie Mac was set up in 1970 to compete with Fannie May. Neither has any sub-prime mortgages on their books, but by 1998 they either held or guaranteed 73% of all conventional US mortgages.

IndyMac a regional bank collapsed last month it had £16bn of assets, there are officially 90 problem banks (out of a total of 8,494) in the USA. A simple rule of thumb is to take non-performing assets and divide them into outstanding loans, a figure above 5% suggests failure. The US savings ratio has reached zero having been negative for four years, this is why US retail sales are growing at only 1.7% (normally they would grow at 3-4%).The speed of the decline mirrors the rate of decline in global demand, which is caused by the collapse in consumer spending in the USA.

In the third quarter US consumption dropped by 3.1% the largest drop since June 1980 and disposable income fell by nearly 9%. GDP in the USA fell by 0.3% in the third quarter, and in the UK by 0.5%.

A positive feedback loop is now firmly in place, falling asset prices require banks to make provisions to their Tier 1 capital, this reduces their ability to lend, which slows the growth in the money supply. Slower money supply growth, means lower asset prices and so the loop begins again. The big concern is that some banks will begin to call in loans in order to restore their Tier 1 ratio. The central bank will always provide liquidity, but the issue now is solvency, ie the value of a banks' liabilities exceeds the value of its assets. When this happens the bank affected will call in loans wherever it can.

This will create another feedback loop where profitable businesses are pushed into insolvency because banks turn off the supply of working capital. Small-medium enterprises are particularly vulnerable. Banks often behave irrationally at this stage of the cycle and internal memo's will instruct regional managers on which sectors to either avoid or reduce exposure to. They will also suggest to their customers that they move to invoice discounting

(this is more profitable for Banks than straight overdrafts and it has more security for the Bank)

The Global economy has been fuelled by credit creation primarily in the West, but as this credit flowed eastwards in the form of US dollars, Asian currency manipulation has created a second round of credit expansion in Asian local currencies. This second round effect is still driving growth and inflation in the East, but for how long? We don't know but it is a reasonable assumption that as the tap is turned off in the West, so with a time lag it will be turned down in the East. And then the twin drivers of Asian GDP growth which are western consumers plus local capital investment spending will lose momentum and growth rates will collapse. The good news is that oil and commodity prices will drop considerably as this happens over the next 12 months.

Households are in difficulty

All of us like to be in monetary equilibrium. This means we have a figure in mind before we open our bank statement. If the balance is as we expect, we are in equilibrium and do not change our spending plans. If the figure is less than we expect, we check each item for accuracy, then we cut our current spending to restore the balance (or if aged under 35 we will borrow the difference to maintain our lifestyle). US household disposable income fell by 9% in the third quarter.

The majority of US and UK households are in disequilibria because of unexpected increases in food and energy prices, and the increase in the cost of borrowed money. They will cut their spending to restore equilibrium. On top of this we have falling wealth: an average a middle class family has lost around 20% of its wealth in the last year, a combination of falling house and equity prices. Wealth is not income but it does affect the willingness to spend and the ability to borrow.

The media

A lot of people are suggesting that it is the media which is talking us into recession. Of course the media plays a major role in distributing data and commenting on it. But it cannot determine the flow of money through the system, this is up to banks and their customers. So if the media decided to be very optimistic from now

on, I find it difficult to see how this change of stance would change the flow. At this stage of the cycle everyone goes into survival mode, it is this which reduces the volume of money and the pressure of its flow. Anyone with a positive outlook would appear foolish or disingenuous at present. The numbers just do not support such a view.

Unfortunately central banks interest rates are no longer effective, it is the rate at which banks lend to each other which matters.

So we have the prospect of a step change downwards in the availability of credit on a global scale, at a time when western consumer discretionary incomes are falling sharply due to the twin pressures of energy and food price hikes.

There is only one conclusion, most western economies will shrink in the next two years. The UK will go into recession by year end, The USA is in recession ,as is Ireland, Denmark, Italy, Germany, and Japan. The rest will follow unless they are oil exporting countries.

The only advice is watch your debtors like a hawk, tune the business, stress test your balance sheet, ie what would it look like with a drop in sales of 20%, could you survive? And build cash for the inevitable bargains which will appear over the next two years.

A year ago I said the party would draw to a close, it has, and now we must live with the considerable hangover. It will be a long one. At least another two years.

Top tips for leading through a recession

Cash cash cash

Try and lower your breakeven point (do you know where it is?)

Be absolutely clear on your value proposition ie why customers should buy from you

Make sure ALL your employees know the value proposition and can articulate it

If you have an overdraft, be prepared for it to be halved by your bank, can you survive on less?

Stress test your balance sheet and P&L, what do they look like if sales drop 20%

Be careful about overseas expansion, Brazil looks superficially attractive but its growth is much more unstable than a mature economy.

Be realistic, do not kid yourself ie do not try and make the numbers work


Your employees will need more support than ever, admit that it will be difficult and then ask them how the business can improve, they will have some great ideas.

Spread your risk across customers.

Do not use the R word as an excuse, in recession the value of total sales should still grow, but it will be at or below the rate of inflation as measured by RPI for two years ie under 4% per annum.

This was updated on Nov 1st 2008

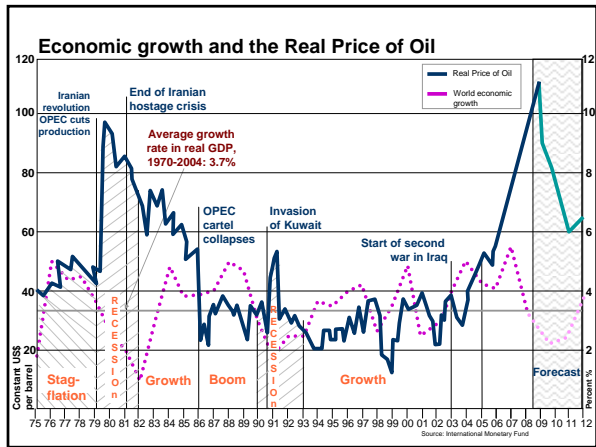
Rmfagg@aol.com.

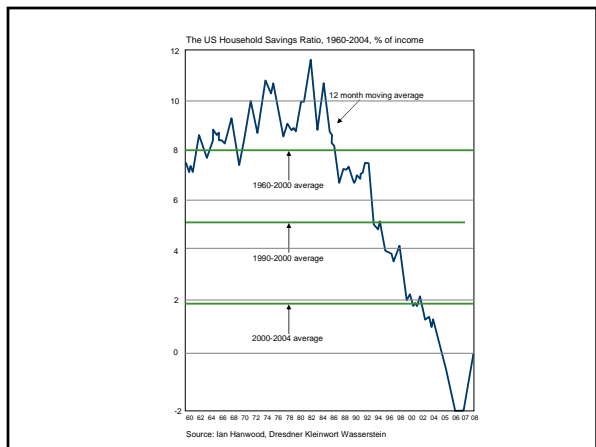


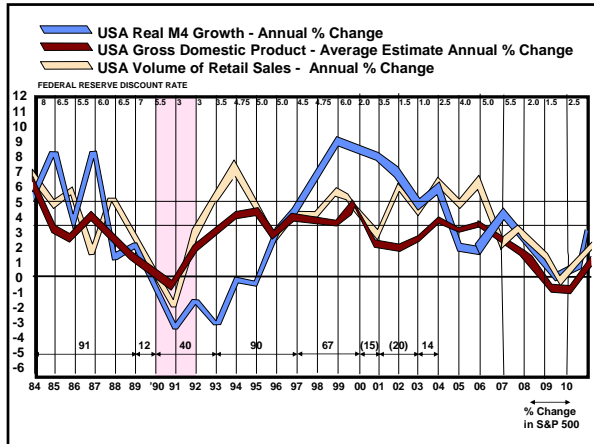
The Perfect Economic Storm: A Global Energy, Financial and Air Transportation Crisis

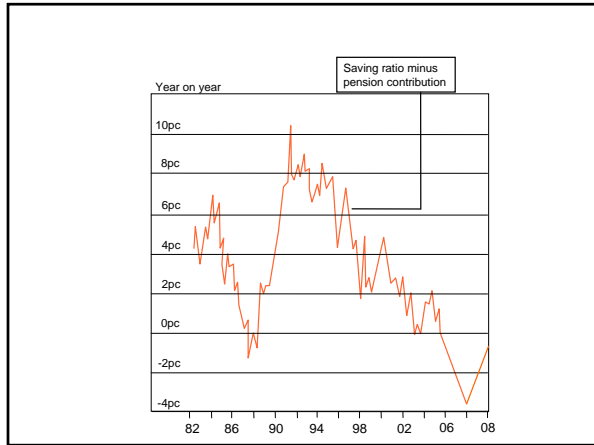
Roger Martin-Fagg

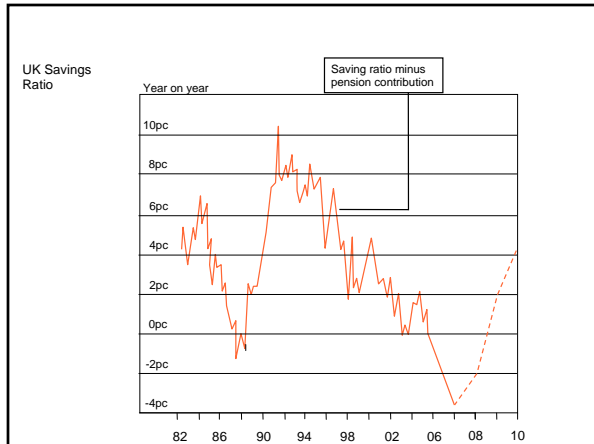
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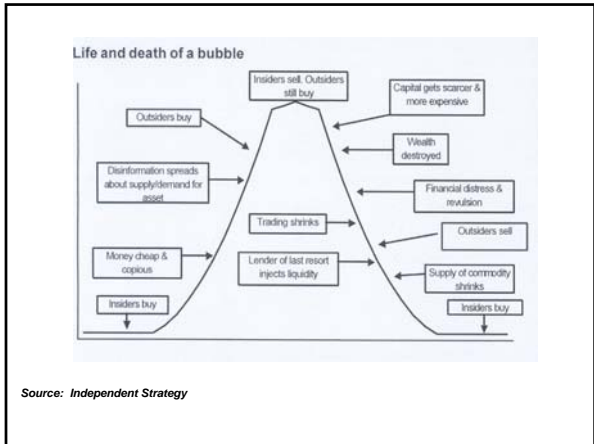












Thank you!

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The Airline Industry Has No Choice But To Change

William S. Swelbar, Research Engineer
MIT

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Some Top of Mind Issues As We Begin

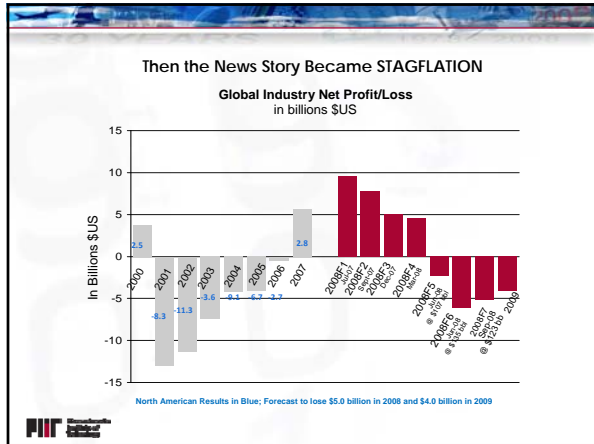
- Things Seem Bad
- Are Things Safe?
- Lots of Cutbacks Being Announced, Who Gets Hurt?
- Lots of Price Increases Being Announced, Who Gets Hurt?
- **Lots of New Fees Being Charged, Anyone Get Hurt?**
- Even More Bankruptcies, Might There Be More?
- Are the Issues Unique to the US Airline Industry?
- Long-haul flying and high fuel costs are proving to be a bad mix.
- Will Mergers Be Good or Bad?
- Will the US Airline Industry Ever Reinvest In Itself Again?
 - For that Matter, Can the Global Industry Find a Sustainable Model?

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2008 Headlines Through May

- Cash Cushion Helps Big Airlines, for Now
- United Reducing Size of Jet Fleet 4 Percent
- Delta Plots Cuts in Jobs, Domestic Routes
 - Fuel Costs Are Blamed For Reduction Effort:
- ALOHA AIRLINES TO SHUT DOWN PASSENGER OPERATIONS AFTER MARCH 31, 2008, ENDING A 61-YEAR TRADITION OF SERVICE TO HAWAII
- Cash-Strapped Airlines: Who's Next to Fall?
- ATA Airlines has shut down all operations after it filed for Chapter 11 bankruptcy protection.
- Champion Air Plans to Shut Down
- Prop planes make comeback as fuel costs rise
- NWA to raise fuel charge, cut capacity
- Skybus Ends Service, Third Airline to Fold This Week

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- ### 2008 Headlines Through Since August
- World News Hammer Markets, Confidence
 - EU Says Europe Economy Probably Already in Recession
 - Aviation Faces Biggest Crisis in History
 - Airlines See Big Traffic Drop and Expect More Bad News
 - Aviation Traffic Figures, 'Worst Since SARS'
 - Middle East Not Immune to Economic Crisis: IATA
 - Financial Turmoil to Affect Fuel Hedging, Financing of Aircraft
 - Asia-Pacific Airlines Face Gloomy Outlook
 - Analysts Warn of Asia Airline Failures as Tourism Slows
 - Financial Turbulence Hits Qantas Bookings
 - Austrian Airlines Privatisation Faces Delay
 - Car Rental Company Laying off Workers
 - Lufthansa to Limit Expansion as Economy Hurts Traffic
 - Russia Begins to Refuse Credit Cards in Worsening Global Crisis

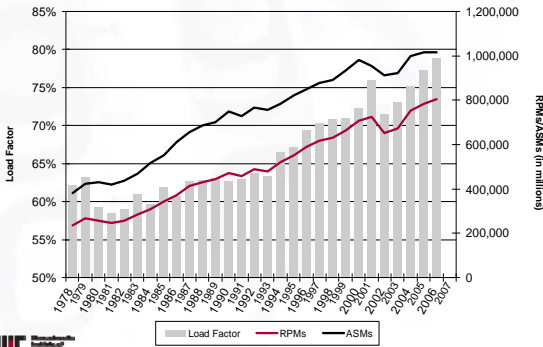


Simply, the Last 30 Years

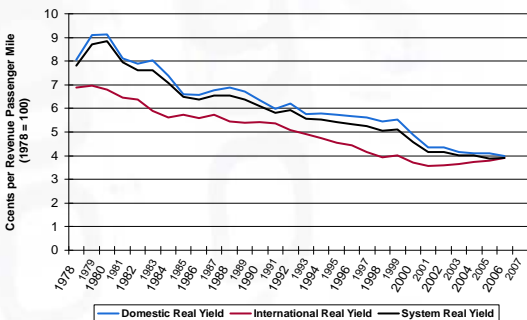
- **Barriers to entry for new and existing carriers were removed**
 - If one had a dollar, an airplane and a certificate: an airline was born
- **Barriers to exit for inefficient carriers were about to be erected**
 - Bankruptcy, government, labor as an internal source of capital
 - Inefficient providers remained in the market
- **Competition ensued: healthy or unhealthy?**
- **Boom and bust cycles describe the industry**
 - And they really are no good for any stakeholder group
- **The search continues for a sustainable model**

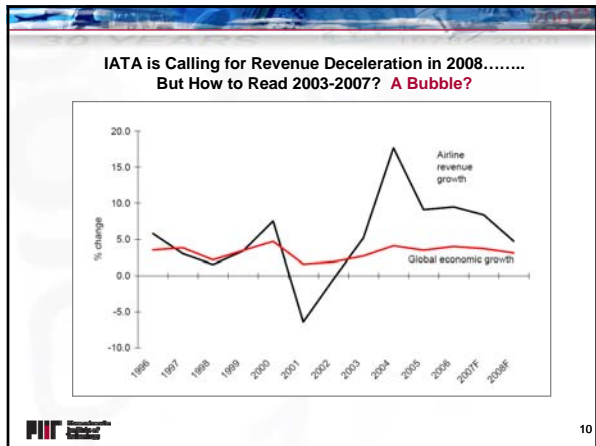


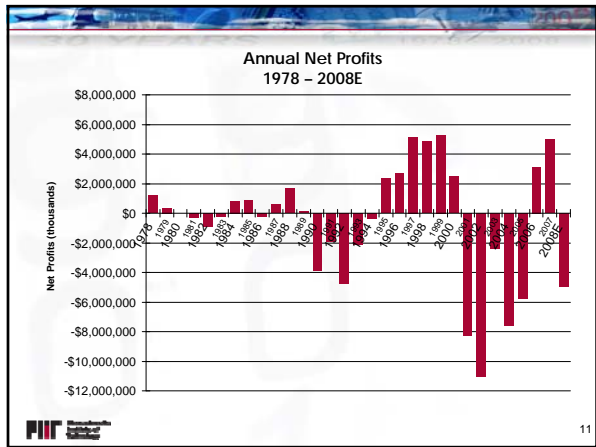
30 Years of Traffic, Capacity and Load Factors for the US Industry - **Not Sustainable!**

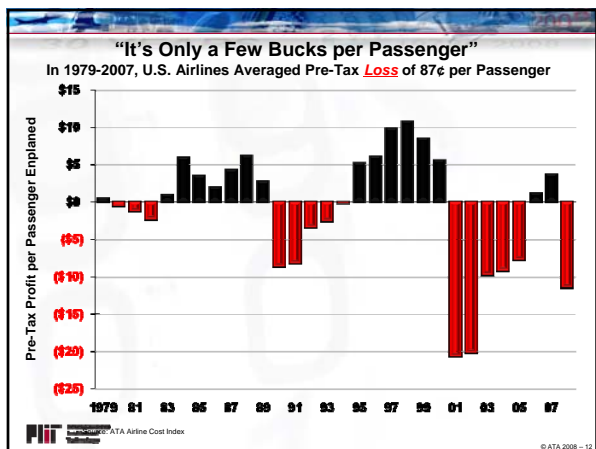


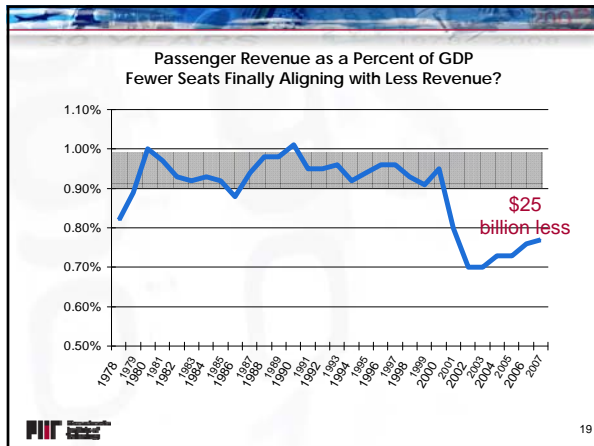
Decreasing Real Fares Have Been the Great Enabler **Not Sustainable!**

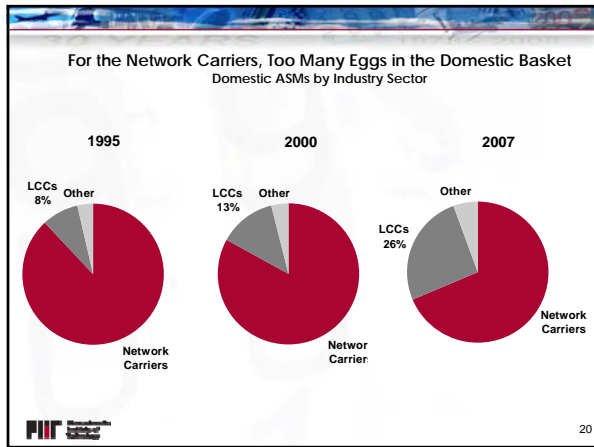


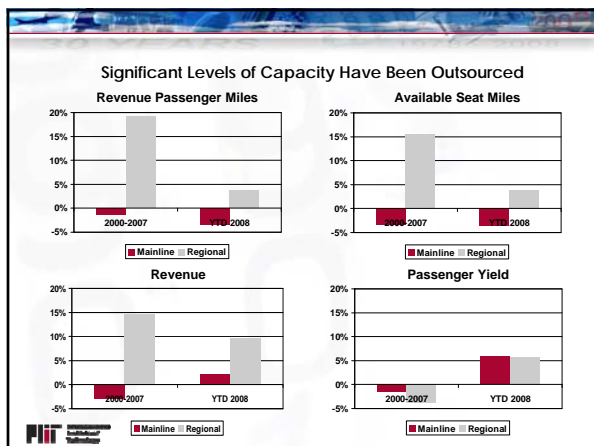












**Events have shaped periods in this industry.
Make NO mistake that the industry is not done.**

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**Already more overhaul underway to remake
the industry than Post 9/11**

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**With most obvious costs cut, the industry
turns its attention to capacity cuts and revenue.**

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So as we begin the process of deemphasizing the domestic market, it is now about global competition.

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Some Passing Thoughts As the Industry Morphs

- Fuel volatility is likely/will to continue
 - Economic forces unlike those in the past?
- Further domestic reductions/change is inevitable
 - Important to watch how cuts evolve in large metro areas with multiple airports that serve to fragment the overall market
- Additional US consolidation activity expected
 - Immediate one to watch will be Continental/United
 - May even be some activity in LCC and Regional Sectors
- Calls for global consolidation activity will be heard
 - Political hurdles to overcome
 - How will current global alliances play a part?
- A total rethink of the makeup of the travel dollar?

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The Next 30 Years:

The industry has met its match and it is fuel.
It is the catalyst to overhaul an airline model that has long needed an overhaul.
It will be better.

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36



About the MIT Global Airline Industry Program



37

About Us

- The MIT **Global Airline Industry Program** represents a large-scale effort that provides the means for MIT and the academic community to make contributions in studying the airline industry and in educating its future leaders. This effort is funded under the umbrella of the **Sloan Foundation's Industry Studies Program**.
- The MIT **Airline Industry Research Consortium** is an outgrowth of the MIT Global Airline Industry Program, sponsored by the Alfred P. Sloan Foundation. Its goal is to engage industry stakeholders in the next phase of the Program's research and to provide a forum for addressing key issues facing the airline industry during this critical period of transformation.
- Another goal of MIT's **Global Airline Industry Program** is to develop a body of knowledge for understanding development, growth and competitive advantage in this industry, which is one of the most diverse, dynamic and perplexing of the world. To further this goal, and to support the goals of the **Sloan Foundation Industry Studies Program** and the goals set forth in establishing the **MIT Airline Industry Research Consortium**, the **MIT Global Airline Industry Program** recently introduced the establishment of the **Airline Data Project**.



38

Members of the MIT Airline Industry Consortium

- Air Canada
- Air Transport Association of America
- Amadeus s.a.s.
- American Airlines
- American Express
- Federal Aviation Administration (FAA)
- Jeppesen Systems
- Lufthansa German Airlines
- Massachusetts Port Authority
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39

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